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IMF instead of development?

Pakistan once again is on the verge of adopting an IMF programme. This decision is being taken by a government that had sought electoral support on the basis of a new economic strategy of sustained growth through human development.

The idea was that enabling the development of human capabilities would place Pakistan on a new trajectory of equitable growth powered by the enterprise, innovation and creativity of all of the people rather than a few. Unfortunately, this pro-people strategy would be negated if Pakistan were to accept the usual conditionalities of an IMF programme. Let us see how.

In this article, we will briefly critique the analytical basis of IMF programmes and indicate recent empirical research to show that such programmes have consistently failed even in achieving their claimed objectives of growth combined with reduced inflation through financial 'stabilisation'. Worse, evidence shows that IMF programmes have a negative effect on human development.

Within the IMF framework, stabilisation is conceived in terms of reducing the twin deficits of balance of payments and the budget deficit. They argue that these twin deficits can be reduced by compressing aggregate demand which in their model would reduce import expenditure and push down inflation. The logical consequence of compressing aggregate demand through raising interest rates and reducing public expenditure is to slow down economic growth. The IMF believes that such 'stabilisation' would accelerate economic growth in the medium term through improving future expectations of entrepreneurs and hence higher investment by them. This is an essentially flawed proposition.

Recent research has shown that investment by, and future expectations of, the private sector are determined not just by stable exchange rates and low inflation but more fundamentally by the institutional structure of a country, particularly contract enforcement institutions and the control of violence in society.

In Pakistan's case, there are additional physical constraints to growth beyond the financial sphere, such as a shortage of electricity, gas and water. Furthermore, the lack of a trained labour force with a highly educated stratum that is capable of innovation is also a key constraint to investment and sustained growth (research by Aghion et al has empirically established that the depth and range of innovations is a key determinant of long-term growth). It is these critical institutional, governance and supply side constraints that are ignored when the IMF stabilisation programmes are undertaken in the belief that 'stabilization' will induce sustained growth.

Neither long-run stability in the balance of payments nor inflation is necessarily susceptible to the IMF medicine of high interest rates, reduced public expenditure and exchange rate depreciation as past experience shows. This is because inflation in Pakistan, as in many developing countries, is triggered by cost-push factors such as the prices of fuel, electricity and food to a far greater extent than demand-pull factors. In fact, inflation in Pakistan is likely to accelerate sharply as IMF conditionalities are met because: (a) the price of electricity and gas will increase in the attempt to cut down the fiscal deficit; and (b) exchange-rate depreciation will increase the rupee prices of imported industrial inputs, thereby increasing the overall inflation rate.

At the same time, exchange-rate depreciation is unlikely to improve the balance of payments for three reasons. First, the lower dollar price of Pakistani exportables resulting from exchange-rate depreciation would be neutralised by domestic inflation. Second, even if the dollar price of exportables could be maintained at a lower level, exporters are unlikely to be able to cater to increased orders for their goods in time due to the physical constraints to increasing export volumes in the short run. These include severe shortages of electricity and gas, bottlenecks at the Karachi port, and transportation constraints. And third, given Pakistan's export structure which is heavily weighted towards low-value added semi-finished goods (yarn, grey cloth, leather, rice), export demand is price inelastic, that is, the growth in demand is proportionately less than the dollar price reduction. Consequently, the total foreign exchange earnings can be expected to fall following exchange-rate depreciation.

On the other side of the coin, Pakistan's imports are largely necessities such as industrial raw materials, intermediate goods, fuel, fertiliser and cooking oil. Therefore, their import demand is also inelastic – that is, the reduction in import demand following an increase in rupee prices associated with exchange-rate depreciation, would be proportionately less than the price increase.

Under these circumstances, the combined export earnings and import expenditure effects of exchange-rate depreciation are likely to worsen the balance of trade and hence the balance of payments, rather than improving it.

Our preceding discussion has argued that the analytical basis of IMF programmes is dangerously flawed as far as the national interest of a recipient country is concerned. We will now briefly indicate that there is overwhelming empirical evidence that IMF programmes have a negative effect on long-term growth as well as on human development.

Barro and Lee (2005) conducted an econometric exercise on data from 130 developing countries that have adopted IMF programmes. They showed that these programmes had a significant negative effect on GDP growth and did not have a significant positive effect on investment, inflation and government consumption. A subsequent study by Dreher (2006) also clearly showed that IMF programmes have a negative effect not only on short term but also long-term economic growth.

An important study by William Easterly (2005) focuses on countries (including Pakistan) where IMF programmes have been repeatedly adopted. The results of the econometric analysis reveal that none of the top 20 recipients of repeated IMF adjustment lending was able to achieve high growth. The conclusion of Professor Easterly is noteworthy: "If the original objective was adjustment with growth, there is not much evidence that structural adjustment lending generated either adjustment or growth".

Not only does the adoption of IMF program conditionalities reduce GDP growth, it also has an adverse effect on human development. For example, the study by Kentikelenis, Stubbs and King (2016) has shown that IMF programmes have a negative effect on both growth and human development. The latest study (forthcoming) by Stubbs et al shows that IMF programmes have a negative effect on public health expenditure.

Earlier, the influential study by Cornia, Jolly and Stewart (1987) shows that the IMF requirement of reduced public expenditure results in lower expenditure on health and education, and thereby reduces human development. Later, our own Mahboob-ul-Haq in his seminal 1990 Human Development Report, concludes that "It is short sighted to balance budgets by unbalancing the lives of people".

It is clear that the analytical basis of IMF programmes is essentially flawed and the assumption that the programme will result in economic growth is disproved by the empirical evidence.

Uncritical adoption of an IMF programme by the present government will effectively mean that they will be setting aside their vision of achieving sustained growth on the basis of human development and social justice. Tragically, their promise of charting a new course for Pakistan's economy will turn to mere whistling in the wind.

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